Keynes, Explained Briefly

If you read the economic textbooks, you'll find that the job market is a market like any other. There's supply (workers) and demand (employers). And the incredible power of market competition pushes the price (wages) to where those two meet. Thus massive unemployment is about as likely as huge unsold piles of wheat: if people aren't buying, it's just because you're setting the price too high.

And yet, as I write, 17.5% of the country is unemployed. Are they all just insisting on being paid too much? Economists are forced into the most ridiculous explanations. Perhaps people just don't know where the jobs are, some say. (Maybe the government should run ads for Craigslist.) Or maybe it just takes time for all those former house-builders to learn new jobs. (This despite the fact that unemployment is up in all industries.) But they're typically forced back to the fundamental conclusion of the textbook: that people are just demanding to be paid too much. It might be for the most innocent of reasons, but facts are facts.

John Maynard Keynes' great insight was to see that all of this was nonsense. The job market is a very special market, because the people who get "bought" are also the people doing all the buying. After all, why is it that people are hired to farm wheat? It's because, at the end of the day, other people want to buy it. But if lots of people are out of a job, they're doing their best to save money, which means cutting back on purchases. And if they cut back on purchases, that means there are fewer people for business to sell to, which means businesses cut back on jobs.

Clearly something is badly wrong with the basic economic theory. So let's go through Keynes' masterpiece, *The General Theory of Employment, Interest, and Money*, and understand his theory of how the economy works.

When you get your paycheck at the end of the week, you spend it. But presumably you don't spend all of it — you put some money away to save, like you were told as a child. Saving is seen as a great national virtue — thus all those Public Service Announcements with talking piggy banks. Everyone knows why: put some money away today and it'll be worth more tomorrow.

But there's a kind of illusion involved in this. Money isn't worth anything on its own, it's only useful because it can buy things. And it buys things because it pays other people to make them for you. But you can't save *people* in your bank account — if fifteen million people are out of work, they can't put their time in a piggy bank for when things are looking up. The work they could have done is lost forever.

So yes, some people can save while others borrow from them — you can let your neighbor buy two iPods in exchange for letting you buy four next year — but the country, as a whole, cannot. At the end of the day, someone has to buy the things we can make. But if everyone's saving, that means people aren't buying. Which means the people making stuff are out of a job.

It's a vicious cycle: if people buy less, companies make less, which means people get paid less, which means people buy less. And so on, until we're all out of work. (Thankfully it doesn't get that bad — but only because some people are refusing to lower their wages. The thing that mainstream economists said was causing unemployment is actually preventing it!)

But this cycle can be run in reverse. Imagine Donald Trump hires unemployed people to build him a new skyscraper. They're suddenly getting paid again, which means they can start spending again. And each dollar they spend goes to a different business, which can start hiring people itself. And then *those* newly-hired people start spending the new money *they* make, and so on. This is the *multiplier*: each dollar that gets spent provides even more than one dollar's worth of boost to the economy.

Now let's look at things from the employer's side — say you run an truck factory. How do you decide how many trucks to make? Obviously, you make as many as you think you can profitably sell. But there's no way to calculate something like that — it's a question about what customers will do in the future. There's literally no way to know. And yet, obviously, trucks get made.

It used to be, Keynes says, that wealthy men just thought investing was the manly thing to do. They weren't going to sit around and calculate what kind of bonds yielded the greatest expected return. Bonds are for wusses. They were real men. They were going to take their money and build a railroad.

But they don't make rich people like that anymore. Nowadays, they put their money in the stock market. Instead of boldly picking one great enterprise to invest in, they shift their money around from week to week (or hire someone else to do it for them). So these days, it's the stock market that stimulates most new investment.

But how does the stock market figure out what profits are supposed to be? In truth, it has no more clue than you do. It's really just based around a convention. We all pretend that whatever the stock price is now is a pretty decent guess and then we only have to worry about the various factors that will cause the stock price to change. We forget about the most basic fact: that nobody has any clue what the stock price should be to begin with.

So instead of people trying their best to figure out which businesses will make money in the future, and investing in those, we have people who try to figure out which stock prices will change in the future, and trying to get there first. It's like a giant game of musical chairs — everybody's rushing not to be the one left standing when the music stops.

Or, you could say, it's like those newspaper competitions where you have to pick the six prettiest faces from a hundred photographs. The prize goes to the person who picks the faces that are most picked, so you don't pick the faces *you* find prettiest, but instead the faces you think *everyone else* will find prettiest. But it's not even that, since everyone else is doing the same thing — you're actually picking the faces you think everyone else will think everyone else will find prettiest! And no doubt there are some people who take this even further.

You might think this means that someone who actually did the work and tried to calculate expected profits would clean up, taking money from all the people playing musical chairs. But it's not so simple. Calculating expected profits is really quite hard. To make money, you'd have to be unusually good at it, and it seems much easier to just guess what everyone else will do.

And even if you were somehow good at guessing long-term profits, where would you get the money to invest? It's in the fundamental nature of your strategy that your investments seem crazy to everyone else. If you're successful, they'll write it off as a lucky fluke. And when your stocks aren't doing well (which is most of the time — they're long-term picks, remember), people will take this as evidence of your failures and pull their money out.

The scary thing is that the more open our markets get, the faster people can move their money around and the more trading is based on this kind of speculation instead of serious analysis. And that's scary because — recall — the whole point of the stock market is to decide the crucial question of what we, as a society, should build for the future. As Keynes says, "When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

The best solution is probably a small tax on each trade. Not only would this raise a ton of money (modern estimates suggest even a tiny tax could raise $100 billion a year), it would help redirect all the brains on Wall Street from these wasteful games of musical chairs to something actually useful.

But even if we solve the problem of the stock market, there's still some irreducible uncertainty. Because whether new investment makes sense always depends on whether the economy will be doing well in the future. And whether the economy is doing well depends on whether there's new investment. So, at the end of the day, investment doesn't depend simply on a careful calculation of future expected yield, but on our "animal spirits," our optimism about the future. It's this factor that exaggerates booms and deepens slumps and makes it hard to get out of a bad situation.

Even more perversely, it means economic performance depends in no small part on keeping businessmen happy. If electing Obama gets businessmen depressed, they might pull back their investments and send the economy into a slump. It doesn't even have to be intentional — they may very well believe that a President Obama is bad for the economy. But when you have a system that only works when businesspeople feel good, their fears become a self-fulfilling prophecy.

The result, Keynes suggests, is that the government will have to step in to prevent the economy from crashing every time rich people get a bit of indigestion.

So that's how we calculate the income side of things, now what about costs? Most costs are pretty clear — you need to buy equipment and hire people. But since you need to make stuff now that you can only sell in the future, one of your big costs is going to be money to use in the meantime. And the cost of money is just the interest rate. (If you get a loan for a million dollars at 5% interest, you're essentially paying $50,000 for the right to use the money now.)

Thus lowering interest rates increases investment — it reduces the cost of getting money, which reduces the cost of making stuff, which means more things can make a profit. And if more things can make a profit, more things get made, which means more people get hired. So what determines the interest rate?

Well, if the interest rate is the cost of money, the obvious answer is the amount of money in circulation. If there's a lot of money lying around, you can get some pretty cheap. Which means that, fundamentally, unemployment is caused by a lack of money: more money (assuming people don't hoard it all) means lower interest rates, lower interest rates (assuming expected profits don't crash) means higher investment, higher investment (assuming people don't stop buying) means more employment, and more employment means higher prices, which means we're going to need more money.

Money is created by the central bank (the Federal Reserve in the US), which decides what they want the interest rate to be and then prints new money (which they use to buy up government debt) until the interest rate is where they want. To get the economy back on track, all they have to do is keep lowering interest rates until investment picks up again and everyone has a job.

But there's one catch: the interest rate can't go below zero. (Keynes didn't think this problem was very likely, but in the US we're facing it right now.) What do you do if the interest rate is zero and people are still out of work?

Well, you can pray that billionaires will start hiring us all to build them giant mansions, but that's no way to run a country. The government has to step in. Instead of waiting for billionaires to build pleasure-domes, the government can hire people to build things we all need — roads, schools, houses, high-speed Internet connections. Although, honesty, it doesn't have to be things we all need. They could hire people to do anything. This is why inspecting the stimulus money for waste is so ridiculous — waste is perfectly fine, the important thing is to get the money into circulation so that the economy can get back on track.

Another good solution is redistributing income. Poor people are a lot more likely to spend money than billionaires. If we take some money from the billionaires and give it to the poor, the poor will use it to buy things they need and people will get jobs making those things.

Remember that money is just a kind of illusion. In reality, there are just people who want things and people who make things. But we're stuck in a completely ridiculous situation: there are lots of people who desperately want jobs making things — they're literally not doing anything else — while at the same time there are lots of people who desperately want things made. It seems ridiculous not to do something about this just because some people have all the little green sheets of paper!

Capitalism seems to go through frustrating cycles of booms and busts. Some people say the solution is just to prevent the booms — raise interest rates so the party doesn't get out of hand and we won't all be sorry the next morning. Keynes disagrees: the remedy "is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom."

Think back to the dot-com era, when venture capitalists were spending all their money laying fiber-optic cable under the street. The right solution wasn't for the Fed to raise interest rates until even punch-drunk venture capitalists could realize all this investment in fiber wouldn't be profitable. The right solution was to *take their money away*. Give it to the poor, who will spend it on something useful, like food and clothing.

So those are Keynes' prescriptions for a successful economy: low interest rates, government investment, and redistribution to the poor. And, for a time — from around the 1940s to the 1970s — that's kind of what we did. The results were magical: the economy grew strongly, inequality fell away, everyone had jobs.

But, starting in the 1970s, the rich staged a counterattack. They didn't like watching inequality — and their wealth — melt away. There was a resurgence in classical economics, Keynes was declared to have been debunked, and interest rates were raised drastically, throwing millions out of work. The economy tanked, inequality soared, and things have never been the same since. For a while people talked about levels of inequality that hadn't been seen since the 1920s. Then they talked about a recession the size of which hadn't been seen since the 1930s.

Once again, Keynes provides us with the instructions on how to get out of this mess. The question is whether we'll follow them.

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